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UNCLAS SECTION 01 OF 03 GABORONE 000745

SIPDIS

JOHANNESBURG PLEASE PASS TO FCS
DEPARTMENT PLEASE PASS TO OPIC, JIM POLAN
DEPARTMENT PLEASE PASS TO USTDA, NED CABOT
DEPARTMENT PLEASE PASS TO USTR
DEPARTMENT PLEASE PASS TO AF/EPS, CYNTHIA AKUETTEH
AND ADA ADLER

E.O. 12958: N/A
TAGS: ECON BEXP EFIN ETRD BC TRADE
SUBJECT: BOTSWANA DEVALUES CURRENCY

¶1. Summary: The Ministry of Finance and Development Planning (MOF) announced a 12 percent devaluation of the Pula on May 29 as well as a restructured formula for calculating the exchange rate. The Pula is currently pegged to a basket of currencies, including the U.S. Dollar, the Yen, the Euro, the Rand and the British Pound. While the peg to this basket of currencies will not be affected by the restructuring, the new system will allow for continuous adjustments through what is known as a crawling peg as well as a widening of the margin between the buy and sell rates for currencies quoted by the Bank of Botswana (BOB). The rationale presented by the MOF for the devaluation and restructuring was to enhance the competitive position of domestic producers and exporters, encourage the development of a local inter-bank foreign exchange market, and provide reassurance to foreign direct investors based on a stable competitive real effective exchange rate. This devaluation could be the first step towards converting to a floating exchange rate system and may enhance its export competitiveness, but the timing of the move has raised eyebrows among members of the financial sector in Botswana as the decision comes two days before the BOB is due to pay out on several long-term bonds. End Summary.

¶2. While the devaluation is being sold as a means of ensuring the future stability of the real exchange rate, the abrupt devaluation and restructuring will have several short to medium term consequences on inflation, the budget, the bond market and investor confidence, and ultimately the type of exchange rate system employed by Botswana.

Importing Inflation

¶3. Devaluing the currency will put immediate upward inflationary pressure on the economy as the vast majority of products sold in Botswana are imported, primarily from South Africa. Dr. Keith Jefferies, former deputy governor of the BOB, told EconOff that inflationary pressure will surely rise, possibly by as much as 5 or 6 percent to between 10 or 12 percent on a per annum basis for a year or so. Dr. Jefferies also said, "The BOB may adjust its inflation band (Note: The BOB sets an annual inflation target band, which is currently between 3-6 percent for the 2005/6 fiscal year), but only temporarily as the inflationary bulge should be short-lived, just as it was for the last devaluation." The MOF last devalued the currency by 7.5 percent in February 2004. Finally, the inflationary pressure created by the devaluation means there are no more foreseeable cuts in interest rates, which remain extremely high at a 14 percent prime rate that stifles local investment.

Budgetary Impact

¶4. There is no getting around the obvious impact this move has on the GOB's fiscal standing, adding an immediate boon to its revenue generation, particularly from diamond sales, which are dollar-denominated and account for nearly 50 percent of government revenue. Over the course of the past couple of years, the GOB has been holding its purse strings tightly following three consecutive budget deficits. But the devaluation will free up a substantial amount of money, potentially $300 million, to spend on much needed infrastructure development projects, many of which have stalled.

¶5. However, given the potential for driving up inflation even further if it acts too quickly, the

MOF's press statement wisely indicates that the new exchange rate system "will be supported by ongoing fiscal and monetary prudence." This suggests that the GOB does not intend to spend the additional cash raised by the devaluation immediately, but rather spread over a period of time. Either way, this devaluation will obviously help what was predicted to be another deficit year.

Investor Confidence and the Bond Market

¶6. Despite the stated objective of reassuring foreign investors, the move is likely to have the opposite impact of shaking their confidence, at least in the short term, following the second major devaluation of the Pula in just 16 months. The previous devaluation of 7.5 percent was done in February 2004, and had the benefit of nearly balancing the 2003/2004 fiscal year books. Former Governor of the BOB, Mr. Quill Hermans, told EconOff, that despite the fact that the devaluation was needed and had been predicted, it constituted a "body blow to investor confidence." Martin Makgathle, CEO of Motswedi securities concurred, saying he believes it has "shaken investor confidence" and is worried about sustaining the perception of Botswana as a stable economic country.

¶7. The biggest losers in the devaluation are bondholders. Given the immediate maturity of its 850 million Pula BW001 bond on June 1, its first ever bond issuance, the additional revenue raised by the devaluation comes at a very convenient moment for the GOB, which must repay these debts. Ms. Kathy O'Connell, CEO of Legae Investors Mutual Fund, told EconOff, "It could have been worse. The Government could have defaulted or extended repayment of the BW001 maturity, and imagine the rating agencies would have had a field day with that one." However, it remains to be seen how the rating agencies will see this exchange rate restructuring, considering the impact it has on the Government's debt obligations, and whether Botswana will retain its investment-grade sovereign credit ratings.

¶8. For foreign bondholders, in particular, the devaluation will have an immediate negative impact if their returns are converted into foreign exchange. Given the lack of any rollover or new bond issuances to coincide with the BW001 maturity, there will be a lot of excess liquidity flooding the Botswana capital market this week. With nothing to put their money into, Botswana Treasury bond yields should drop as money is shifted into Bank of Botswana Certificates, and a significant proportion is likely to be repatriated overseas.

¶9. Portfolio investors will also be negatively impacted as the value of their investments falls correspondingly to the devaluation. Dr. Tebogo Matome, CEO of the Botswana Stock Exchange, told EconOff that the devaluation will clearly cost portfolio investors money, and it will take time to bring them back to this market. In addition, Dr. Matome noted that portfolio investment typically leads the way for foreign direct investments (FDI), so the negative impact on portfolio investments could stem the flow of FDI, with a correspondingly negative impact on the GOB's efforts at diversifying the economy.

¶10. Mr. Brian Alexander, Managing Director of Andisa Capital, a financial services company incorporated under the Botswana International Financial Services Center (IFSC), told EconOff that the restructuring of the exchange rate system is "definitely positive" for investment in that we won't see large scale revaluations in the future, which should add stability to the market. He also said, as an IFSC company that earns money only in foreign exchange, the move would boost profits. Mr. Wayne Osterberg, CEO of Stockbrokers Botswana, told EconOff that he agreed the restructuring is a good idea, but lamented that the decision to devalue the currency was done immediately in a single move, rather than incrementally under the newly established system.

Moving Towards a Free Float?

¶11. Dr. Jefferies, who departed the BOB only recently, told EconOff that the restructuring of the exchange rate mechanism signals a first step towards establishing a floating exchange rate in Botswana. In addition to the continuous adjustments described

in the new policy, the Bank of Botswana has also increased the margin between the buy and sell rates for currencies quoted by the Bank to plus or minus 0.5 percent from the preexisting 0.125 percent. This move should, as the MOF suggests, catalyze the development of a market-based inter-bank foreign exchange market in Botswana, which could in turn set the benchmark for converting to a floating system. The MOF's press release explicitly states, "As the foreign exchange market among the primary dealers develops, further increases in the width of the band around the central rate will be announced." This is a clear indication of the BOB's attempt at letting the market determine the real exchange rate and bring a greater level of stability to the system.

¶12. EconOff asked Mr. Osterberg about a potential shift to a floating system, and he noted that a crawling peg system served as a "useful steppingstone for converting to floating systems in Chile, Israel and Colombia," and could likely do the same for Botswana.

Conclusion

¶13. Assuming the immediate negative inflationary and investor confidence impacts are short-lived, the GOB's decision to shift to a crawling peg system should bring greater stability to both Botswana's fiscal circumstances and its burgeoning capital markets.

HUGGINS